SAR POLICY BRIEF No. 18

One year after the tax reform was implemented, beyond the political debates in Bucharest, the governments' hesitations and Brussels' hypocrisy, **Sorin Ioniţă** offers you

THE TRUTH ABOUT THE FLAT TAX

BUDGET REVENUES HAVE INCREASED, AS PREDICTED

THE PARADOX IS, WE HAVE MORE FUNDS THAN OUR STATE CAN MANAGE EFFECTIVELY

It is natural that the opposition in Bucharest criticizes the ruling power, reinterpreting data creatively in order to paint a gloomy picture of the current governance. Up to a point, this is how things should be in a democracy. It is also understandable that West European politicians are worried by the increasing competitiveness of the East-European economies, to which fiscal reforms have contributed substantially. This is why officials from old EU members states are criticizing today the Romanian government for one of the few bold steps it has made in the right direction.

May 2006

What is more difficult to understand is the lack of assertiveness of our center-right cabinet, who is slow in responding to its critics, at home and abroad, regarding the effects of the fiscal reform introduced in January 2005, in the very first days after taking office following the November 2004 elections.

First, the facts: Fig. 1 overleaf shows the structure of public revenues in Romania, and the sums collected, by component, in the interval Jan 1-Apr 16 of the two post-reform years, 2005 and 2006[1]. The fiscal reform package consisted in more than just the introduction of a flat tax, though in the public's mind it became strongly associated with this eye-catching label. In fact, two major changes were operated:

1. On the personal income tax (item 1 on the chart) progressivity was eliminated and a 16% flat rate replaced the previous complex system with five brackets.

2. On the corporate profit (item 2), where the rate was already flat, the percentage was simply reduced from 25% to 16%.

A number of additional sources of personal revenue, which were previously taxed separately and very ligthly (for example, 1% on capital market gains), were included in the taxable base. In general, the logic was to broaden the base and reduce the general

[1] Data available on the Ministry of Finance's webpage (www.mfinante.ro) where they are updated regularly. A more user-friendly reporting format would be advisable, though.

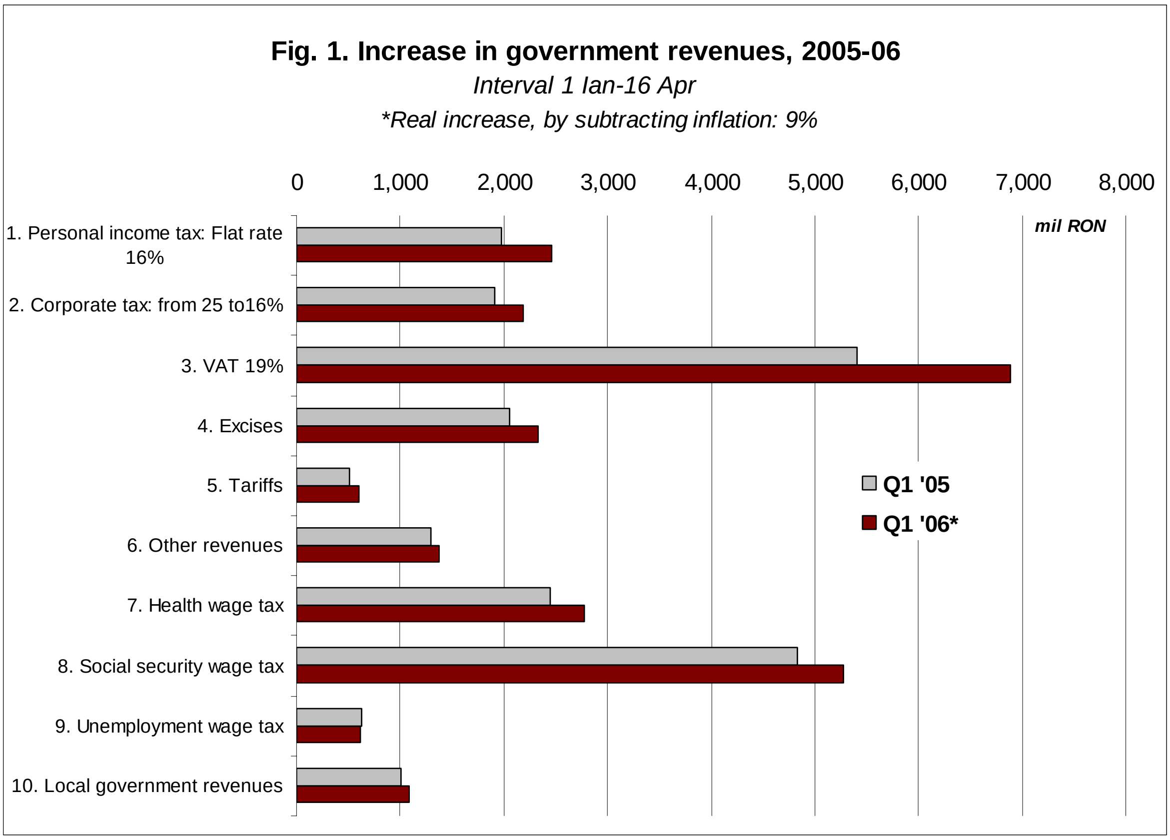
Fig. 1. Increase in government revenues, 2005-06
Interval 1 Ian-16 Apr
*Real increase, by subtracting inflation: 9%
0
1,000
2,000
3,000
4,000
5,000
6,000
7,000
8,000
mil RON
1. Personal income tax: Flat rate 16%
2. Corporate tax: from 25 to16%
3. VAT 19%
4. Excises
5. Tariffs
6. Other revenues
7. Health wage tax
8. Social security wage tax
9. Unemployment wage tax
10. Local government revenues
Q1 '05
Q1 '06*

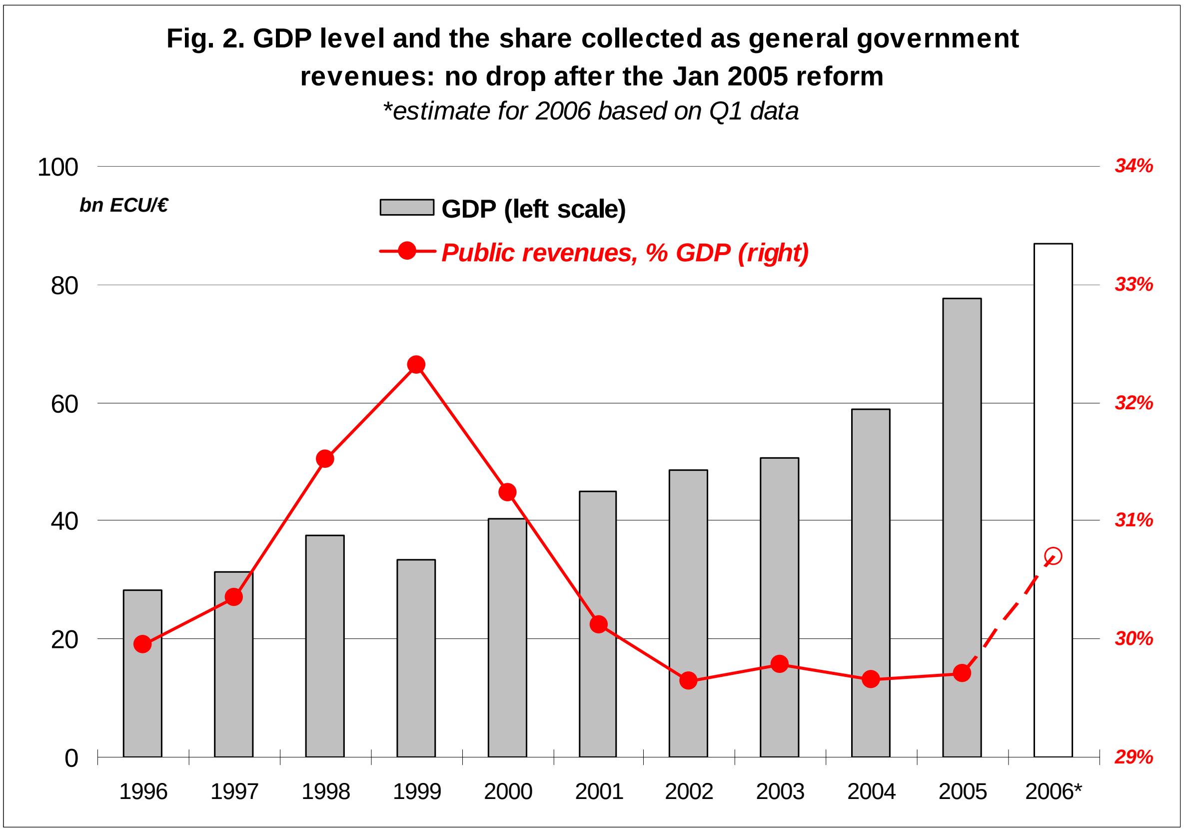
Fig. 2. GDP level and the share collected as general government revenues: no drop after the Jan 2005 reform
*estimate for 2006 based on Q1 data
bn ECU/€
GDP (left scale)
Public revenues, % GDP (right)
100
80
60
40
20
0
34%
33%
32%
31%
30%
29%
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006*

rate, in order to ensure more horizontal fiscal equity.

The collection data prove clearly that the reform worked largely as predicted. Fig. 2 displays the budget revenues in 2005, as a fraction of GDP, at exactly the same level as before, though the individual taxpayers, and especially companies, were left with a lot more funds at their disposal. In the liberal, pro-market view of SAR, this is a success. No matter what the macroeconomists may believe, in their fixation for abstract equilibria, the "natural state" of my money is in my pocket, not in the coffers of the Treasury. I might accept to give up some in exchange for well defined services, but imbalances in the national accounts should be addressed at source, not by confiscating and neutralizing my private revenues. In other words, the goals of fiscal policy should be to collect money fairly and efficiently in order to finance public goods, not to conflate or deflate aggregate macro indicators, and in this respect the Romanian flat tax represents an improvement. In addition, if from three million tax return forms before, the tax offices have now to process less than one million (from individuals with irregular incomes), we believe this is also a good thing, reducing the administrative costs of the state.

It is therefore strange when a former minister of finance (Social Democrat) criticizes the current cabinet for the low level of government revenues: they may be indeed low at 29.7% in 2005, but this is exactly the same percentage as in his mandate, before the reform. Since this is now achieved with a lighter fiscal burden, one would say this is a step forward, not a setback. If anything, it is the Social-Democratic government who should be blamed for the relative drop in public revenues after 2001, which had peaked at 31-32% before they came into office. In fact, it would be unfair to blame the Social Democrats: the taxation yield fluctuates less over short periods of time than the GDP, so the ratio tends to go up in times of recession (as it happened in 1998-2000) and down again towards its structural level when economic growth resumes (like in 2001-02).

It is actually more important to analyze the current dynamics of public revenues in Romania. Fig. 1 suggests a robust increase in real terms on almost all components in the first part of 2006. This is crucial: the same thing happened at the beginning of 2005, but many people remained skeptical, arguing that those revenues were actually taxes accrued in the year before the reform, paid with a time lag. However, if the positive trend continues this year, there must be other factors playing a role as well. In fact, it is precisely the fiscal reform of 2005, including the flat tax, which may function as a trigger for higher public revenues, which for the first time in the last decade may reach a sustainable level above 30% of the GDP. Projecting over the whole year 2006 the results of the first quarter, the net increase due to the tax reforms is likely to be around 1% of GDP (Fig. 2).

Good news for the EU

These findings should come as a comfort to everybody, including the Western officials who keep repeating the meaningless criticism that they don't want to "make up with EU money for the public revenues gap generated by the tax decreases in Romania". There are two pieces of good news for them, especially for the finance ministers of the EU, who apparently have just drafted a report on this topic: (i) there is no drop in budget revenues so far; (ii) even more, it is precisely such type of reforms that may lead to a sustainable increase in budget revenues in Romania, both in absolute sums and as a fraction of GDP.

They probably know these things already, having the same data at their disposal – at least, we hope they do. But choose to play the hypocritical game of being concerned for our own good, because they too are politicians. Faced with the strong economic dynamism of Eastern Europe, from which everybody wins, including West European multinationals investing in our region, instead of explaining to their own voters the necessity of economic and labor market reforms at home, they take the easy path of blaming "unfair fiscal competition" from the East and trying to twist the arm of weak governments in Bucharest, Bratislava, etc into submission.

The situation is absurd: when EU-financed programs get stuck in Romania, or advance at snail pace, in most cases this is not for lack of domestic money to cofinance them. Rather, the cause is the shortage of management capacity and human resources, or the lack of cooperation between – and incentives within – the implementing institutions, as our in-depth report shows[2]. It may sound paradoxical, but the Romanian public sector eligible for EU funds is approaching fast the situation where it will get more money than it can manage effectively, including those from the national treasury. The real source concern, for us and the EU finance ministers, should be the big projects approved in 2000-01 and that are carried out very slowly, for all sort of institutional reasons.

What mistakes did the government make

If the fiscal policy suffers, it is because of too little, not too much radicalism. The government stumbled in 2005 over some crucial elements of the reform, especially on its flat tax component: today, more than one year after the changes, it is still not clear how capital gains or real estate transactions will be taxed, while a special, preferrential regime for micro-enterprises was left in place which is used on a large scale to avoid wage taxes. The new power shied away from entering these senzitive areas where many influential people and opinion leaders earn their money. Moreover, agricultural land and most farms contribute next to nothing to the budget directly. True, many farmers are poor, but leaving 30-35% of Romania's population outside the tax base is not a sustainable option, since they too consume services. What had to be done was just the logical consequence of the first step: if tax rates above 16% were reduced, those below this level should have been raised, and the tax loopholes eliminated, in order to ensure fiscal equity.

Also, it would have been better if the government had set the new rate on personal income and corporate profit at 18%, as SAR recommended when it launched the idea three years ago[3], instead of the 16% resulted from the mysterious calculations of their party experts. Now, of course, it is difficult politically to increase it. On the other hand, it is also true that many people who want higher budget revenues have opposed fiercely the modest attempts of the government to actually do this: for example at the beginning of 2006, when the health minister tried to eliminate health fund contribution exemptions for freelancers.

The lack of follow up after the first bold steps of reform have left many issues in a state of limbo: ethically, since many well-off individuals with multiple sources of income are still taxed more ligthly than ordinary blue collars, for example (though most in-your-face inequities that existed before 2005 were indeed addressed); but also financially, since by some estimates the incomplete reform equivalates with forgone budget revenues of about 1.5-2%[4].

A certain indecisiveness and the typical lack of attention of the Ministry of Finance for local government issues also leaves some potential unexploited, in the area of real estate property. The current tax on land and buildings is small and regressive (the more valuable the property, the less you pay as a fraction of it), because of the awkward method to determine the fiscal value of properties. The attempts to improve property taxation were abandoned last summer, when the minister of finance was replaced, and there has been little movement on this front since then. If property taxation is reformed, and the system to assess and register properties and market value is created[5], the consolidated budget stands to gain at least 0.5% of GDP. This sum will go directly to local governments, who are the most in need of extra funds for financing investments, and who in general have a higher absorption rate of EU funds.

What needs to be done

The following months will confirm if the positive trends we have noticed so far are indeed sustainable. But it would be a mistake for the government to backtrack now, when the beneficial effects of the 2005 fiscal reform are beginning to show. On the contrary, they must pull themselves together and take the few remaining steps to complete and consolidate the reforms. The likely result will be a stabilization of budget revenues around 33% of the GDP, as follows:

- Extra 1% structural gains as a result of reforms implemented so far (Fig. 2);

[2] Sorin Ioniţă, *Too much to handle? Review of EU funds absorption in Romania*. January 2006. Available from http://www.policy.hu/ionita/research.html

[3] *The true fiscal revolution: let's adopt a flat tax in Romania*. SAR Policy Brief no.2, August 2003.

[4] Gabriel Biriş, in *Gândul*, October 24th 2005.

[5] A PHARE project with Danish assistance has just begun, if only the government will take advantage of it.

- Extra 1.5-2% if the existing loopholes are closed and the flat tax becomes indeed universal and flat, irrespective of the nature of income (some things will happen anyway: for example the special regime for micro-enterprises will dissapear in January 2007);
- Extra 0.5% from property tax reform.

In SAR's opinion 33% of GDP is more than enough for the budget for the time being, given the current capacity of our public sector to use money effectively, especially on programs and projects. Spending a lot does not necessarily mean spending wisely; when clear and transparent rules are enforced and no waivers given, our absorption capacity is not very high, as the recent experience has shown. In the same time, EU accession is not as expensive for public budgets, central and local, as many people believe: 1-1.5% of GDP (see study in footnote 2).

The figure of 33% may increase in the next decade, as the sizable Romanian agro sector – and the peasantry in general – is gradually drawn into the formal, monetized (hence, taxable) economy, and the general welfare grows at least towards the level of the countries from Central Europe which joined the Union in 2004. We should also allow more time to our public administration to increase the quality of spending of the money they already have. In fact, 33% is more than what US collects today, and more than France or Germany were collecting when they were at our level of development. We should beware blind benchmarking of agrregate indicators, when we don't understand very well what is behind them, and across countries where social realities are very diverse.

And, after all, it may be that Western Europe itself is not perfect in this respect, collecting and spending publicly too much of the social wealth. A recent study published for the European Central Bank shows precisely that: the most dynamic and successful developed countries today are those with a leaner state and efficient public spending[6]. The authors conclude that an optimal level would be somewhere between 30 and 35%. Ireland, mentioned so often today in Romania as a model to follow, collects exactly 33% of its GDP.

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[6] Afonso, Schuknecht and Tanzi, 2006. *Public sector efficiency: Evidence for new EU member states and emerging markets*. Working paper series no. 581, ECB.